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In the Supreme Court of the United States.

OCTOBER TERM, 1923.

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE, petitioner,
v.
LOUIS STEARN. } No. 262

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE, petitioner,
v.
JOHN G. WHITE. } No. 263

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE PETITIONER.

STATEMENT OF THE CASE.

These writs of certiorari are to review judgments of the Circuit Court of Appeals for the Sixth Circuit, affirming judgments of the United States District Court for the Northern District of Ohio. The respondents here were plaintiffs in the District Court and brought actions against the Collector of Internal Revenue to recover amounts paid as income taxes

after appropriate proceedings had been taken before the Bureau of Internal Revenue. The District Court decided in favor of the plaintiffs, rendering judgments against the Collector, and these judgments have been affirmed by the Circuit Court of Appeals.

THE FACTS.

Each of the plaintiffs was a stockholder in the National Acme Manufacturing Company, an Ohio corporation, whose assets were acquired by another corporation called The National Acme Company. The question involved is the amount of taxable income received by the stockholders in the transaction. One opinion was written in the two cases by the Circuit Court of Appeals, and the question involved in each is the same, the only difference in the facts being that Stearn, respondent in No. 262, was the owner of 105 shares of stock of the National Acme Manufacturing Company, while White, respondent in No. 263, was the owner of 670 shares.

On March 1, 1916, the National Acme Manufacturing Company had an outstanding capital stock of $4,000,000, divided into $1,500,000 preferred stock and $2,500,000 of common stock, each share being of the par value of $100.

On March 15, 1916, a stock dividend of 100 per cent was declared by the corporation, payable to the holders of common stock, which was thereby increased to $5,000,000.

On November 8, 1916, arrangements had been made for the retirement of the preferred stock, so

that for purposes of this case the entire outstanding capital stock of the company on that date was $5,000,000 common stock, consisting of 50,000 shares of the par value of $100 each.

On November 8, 1916, an agreement was made between W. D. B. Alexander, A. W. Henn, and E. C. Henn, parties of the first part, designated as "vendors," and Messrs. Eastman, Dillon & Company, parties of the second part, designated "purchasers," which agreement is set forth beginning at page 7 of the transcript in the White case, No. 263.[1] The agreement, after reciting that the vendors were the owners of more than 14,000 shares of the common capital stock of the National Acme Manufacturing Company and that the purchasers desired to acquire the same and such other shares as might be deposited thereunder, provided as follows:

> First. The vendors agree to, and will sell all their said shares of common capital stock to, and the purchasers agree to and will purchase the same from them, as well as any and all shares of the common capital stock of said The National Acme Manufacturing Company, the holders of which deposit the same with the depositary hereinafter named, subject to the terms of this agreement, at and for the price of three hundred dollars ($300.00) per share, payable, one-half in cash and one-half in securities, as hereinafter set forth; provided, however, and this contract is made

[1] The page references are to the transcript in No. 263 unless otherwise noted.

upon the express condition, that it shall not become operative unless, on or before December 1st, A. D. 1916, at least eighty per centum (80%) of the entire outstanding common capital stock of said company is deposited hereunder, for sale in accordance with the terms hereof, with said depositary.

The second paragraph of the agreement recites that the vendors have exhibited to the purchasers a financial statement of the company and have made certain representations and provides that the purchasers might, if they desired, make an examination of the company's books and properties, and should on or before December 4th advise the vendors of the results of their examination. Upon certain contingencies which might be revealed by the examination the agreement was to be cancelled, otherwise it was to be carried out. Under the third paragraph the vendors were to deliver to the Cleveland Trust Company as depositary certificates of all their shares of the common stock duly endorsed for transfer and subject to the terms of the agreement and were to attempt to procure the deposit by all the other stockholders of their shares and to constitute the vendors attorneys in fact and proxies of the depositing stockholders to vote the stock in such manner as might be necessary to carry out the purposes of the agreement. If and whenever, on or before December 1, 1916, the depositary should notify the purchasers that there had been deposited with it at least 80 per cent of all the outstanding stock, the purchasers

agreed within five days to deposit with the Cleveland Trust Company or for its account, at the Chase National Bank in the City of New York, the sum of $500,000 and the further sum of $7,000,000 within five days thereafter.

By the fourth paragraph the purchaser and vendors agreed to cause to be incorporated under the laws of the State of Ohio a manufacturing corporation, with powers generally similar to those of the National Acme Manufacturing Company, under the corporate name of The National Acme Company, or such other name similar thereto as the parties might desire. That corporation was to have an authorized capital stock of $25,000,000 of common stock, divided into 500,000 shares of the par value of $50 each. Upon the organization of that corporation the purchasers and vendors were to cause such proceedings to be had by its stockholders and directors as would cause it to purchase all the property and assets of the National Acme Manufacturing Company, subject to all its outstanding contracts and liabilities in consideration of the sum of $25,000,000, payable by its entire authorized issue of stock, and to issue such stock in payment therefor. The purchasers and vendors also agreed to use their best endeavor to cause such proceedings to be had by the stockholders and directors of the old company as would cause all its property and assets to be sold to the new company at the price and on the terms set forth, and to receive in payment therefor the capital stock of the

new company. And the purchasers and vendors also agreed to cause all the stock of the new company, except nine qualifying shares for directors, to be issued to the Cleveland Trust Company, depositary, to be held and distributed by it as provided in the fifth paragraph of the agreement.

By the fifth paragraph the depositary was to distribute the shares of stock and the $7,500,000 as follows: The purchasers were to receive 250,000 shares less four qualifying shares—that is, one-half of the stock of the newly organized company, and the depositing stockholders of the old corporation were to receive the $7,500.00 on the basis of $150 per share. The remaining half of the stock of the new corporation—that is, 250,000 shares, excluding five qualifying shares—was to be retained by the trustee until May 31, 1917, unless and to the extent that the purchasers might consent to earlier deliveries, at the expiration of which time it was to cause the stock to be assigned and transferred to the depositing stockholders or their assignees *pro rata*. The agreement further provides for distribution by the depositary of the cash and stock in case the entire amount of the stock of the old company should not be deposited.

The vendors "being the active executive officers" of the old company, agreed to accept and retain, if elected thereto, for a period of five years after its organization, the same or similar positions with the new company, "it being the desire of both parties hereto that the present management of the business

be not interfered with by its transfer to the new company." Upon the organization of the new company its board of directors was to consist of nine, of whom four were to be nominated by the purchasers and five by the vendors. Both purchasers and vendors agreed to cause the new corporation to make application to have its stock listed upon the New York, Boston, and Cleveland stock exchanges. The expenses of the formation of the new company, transfer of assets and the dissolution of the old company, which was to be effected as soon as it legally might be, were to be borne by the new company. It was finally provided that if, in carrying out the terms of the contract, it was deemed advisable to make any modifications, the matter should be submitted to two gentlemen named, who might make such modifications or additions as they deemed advisable or desirable "other than change in price of the stock sold or time of payment therefor which they [had] no power to modify."

This agreement was carried out, each stockholder of the old company receiving for each share of his stock $150 in cash and five shares of stock in the new company. The courts below held that for income-tax purposes the transaction represented a sale by each stockholder of one-half of his stock in the old company for $150 in cash. The contention of the Government is that it represented a sale of his entire stock for $150 in cash and five shares of stock in the new company of the agreed value of $30 per share.

THE STATUTE.

The statute is Section 2 (a) of the Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, 757, as follows:

> That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

ARGUMENT.

I.

The transaction between the respondents and Eastman, Dillon & Company was in fact and legal effect a sale by the respondents of all their stock in the National Acme Manufacturing Company for $300 a share, payable $150 in cash and $150 in securities of another corporation.

The transaction, of course, must be considered in the light of the agreement. That agreement was evidently drawn with care, is free from ambiguity, and expresses clearly a definite intent. The vendors agree to and will sell all their shares, and the purchasers agree to and will purchase the same from them, as well as any and all shares, the holders of which deposit them with the depositary named, for the price of $300 per share, payable one-half in cash and one-half in securities "as hereinafter set forth." Nothing could be clearer, and it is the position of the Government that this agreement amounted exactly to what it said and that the transaction was a sale by the respondents of their stock in the National Acme Manufacturing Company for $300 a share, payable half in cash and half in securities of another corporation. The contract was made upon the express condition that it should not become operative unless at least 80 per cent of the entire outstanding stock should be deposited "for sale." Of course it is apparent that the purpose of Eastman, Dillon & Company, the purchasers, was to become the owners of a half interest in a very profitable business, and

we all know that one who holds 50 per cent of the stock of a corporation practically controls it, where the other half is held by numerous stockholders. The other terms of the agreement show that the purchasers were not buying one-half of the stockholders' stock. They were purchasing the company for the purpose of reorganizing it and placing themselves in control, so the agreement provides that they shall have an opportunity to investigate the representations made by the vendors with respect to the earnings of the company and the title to the company's property, and, if that examination was unsatisfactory, the purchasers would not be required to carry out the agreement.

The vendors, owning 14,000 shares out of a total issue of 50,000 shares, were to deposit their stock with the depositary, as were all other stockholders who wished to take advantage of the agreement. The stock, as is usual in such transactions, was to be endorsed in blank for transfer, so as to constitute the vendors attorneys in fact and proxies, which would enable them, of course, to vote the stock as it became necessary to transfer the assets to the new company and dissolve the old one. The use of the words "vendors" and "purchasers" throughout the agreement shows that these words were used in no other sense than the usual one of such language in similar agreements. The provision contained in subdivision B of paragraph five of the agreement is significant. If less than the entire

amount of the capital stock of the National Acme Manufacturing Company was deposited, the depositary was to retain ten shares of stock of the new company and $150 in cash on account of each share not deposited until "adjustment for the purchase of such nondeposited stock under the laws of Ohio, or otherwise, can be had." The "purchasers" were to make whatever adjustment might be necessary to acquire such nondeposited stock and to that end might use the shares of stock and money retained by the depositary, and, when the nondeposited stock had been acquired "by the purchasers," the depositary was to turn over to the purchasers any shares or money then remaining in its hands, provided, however, that the vendors, if they desired, should have the right to proceed "in the purchase of such nondeposited stock to the extent and upon the terms which may be deemed equitable" by Messrs. Wiggin and Goff, and with the further provision that in lieu of their portion of the retained stock the purchasers might substitute and deposit such other collateral as might be approved by Messrs. Wiggin and Goff. The concluding paragraph of the agreement is also significant, providing for modifications or additions to be made by Messrs. Wiggin and Goff but denying them power to modify in regard to "prices of the stock sold or time of payment therefor."

II.

The excess of both the cash and the value of the National Acme Company's stock, received by the respondents, over the value of the National Acme Manufacturing Company's stock as of March 1, 1913, or, in the case of stock purchased since that date, its cost, was income for the year 1916.

The transaction whereby the respondents disposed of their stock in the National Acme Manufacturing Company comes clearly within the language of the act taxing profits derived from "sales or dealings in property."

The receipt of property may as well constitute income to the taxpayer as the receipt of money. In *Peabody* v. *Eisner*, 247 U. S. 347, the value of Baltimore & Ohio Railroad stock owned by the Union Pacific Railroad and distributed by the latter to its stockholders as a dividend was held to constitute taxable income. See also *Eisner* v. *Macomber*, 252 U. S. 189; *United States* v. *Phellis*, 257 U. S. 156. The respondents converted property of one kind into cash and other property having an agreed value. This resulted in taxable income.

The plaintiff sold his stock in the National Acme Manufacturing Company to Eastman, Dillon & Company for $150 cash per share and securities in a new, separate and distinct corporation, and thereby realized a gain severed from his capital interest in the National Acme Manufacturing Company, the old corporation. He received in cash his capital interest in that company, namely, the par value of $100 a

share, and in addition realized a profit per share of $50 cash and securities in another corporation. Before the transaction his stock in The National Acme Manufacturing Company reflected his original capital investment plus the accretions which had resulted through the company's business activities and constituted its surplus, a surplus in which he as an individual stockholder had no property interest except as it increased the valuation of his capital. When, however, he sold that stock for its par value and received in addition cash and securities in another corporation it is clear that he received assets of exchangeable and actual value severed from his capital interest in the old company.

In support of the foregoing attention is called to the cases of *United States* v. *Phellis*, 257 U. S. 156, *Rockefeller* v. *United States*, 257 U. S. 176, and *Cullinan* v. *Walker*, 262 U. S. 134.

In *United States* v. *Phellis, supra*, a New Jersey Corporation, having a large surplus of accumulated profits transferred its assets and good will to a new corporation incorporated under the laws of Delaware, with an authorized capital stock almost four times that of the old corporation. The new corporation had the same stockholders and officers and did the same business as the old corporation. The old corporation continued to exist, its only assets being debenture bonds equivalent to its outstanding common stock. The stock of the new corporation was distributed to the stockholders of the old corporation, two shares for one. This Court held that the value of the stock thus dis-

tributed was taxable as income. Among other things the Court said (pp. 169, 170):

> Hence the inquiry must be whether the shares of stock in the new company received by claimant as a dividend by reason of his ownership of stock in the old company constituted (to apply the tests laid down in *Eisner* v. *Macomber*, 252 U. S. 189, 207), a gain derived from capital, not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested, and coming in, that is, received or drawn by the claimant for his separate use, benefit, and disposal. * * *
>
> Upon the face of things, however, the transfer of the old company's assets to the new company in exchange for the securities issued by the latter, and the distribution of those securities by the old company among its stockholders, changed the former situation materially. The common stock of the new company, after its transfer to the old company and prior to its distribution, constituted assets of the old company which it now held to represent its surplus of accumulated profits—still however a common fund in which the individual stockholders of the old company had no separate interest. But when this common stock was distributed among the common stockholders of the old company as a dividend, then at once—unless the two companies must be regarded as substantially identical—the individual stockholders of the old company, including claimant,

> received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit. Such a gain resulting from their ownership of stock in the old company and proceeding from it constituted individual income in the proper sense.
>
> * * * the value of the New Jersey shares immediately prior to the transaction reflected the original capital investment plus the accretions which had resulted through the company's business activities and constituted its surplus; a surplus in which, until dividend made, the individual stockholder had no property interest except as it increased the valuation of his capital. It is the appropriate function of a dividend to convert a part of a surplus thus accumulated from property of the company into property of the individual stockholders; the stockholder's share being thereby released to and drawn by him as profits or income derived from the company.

It will be noted that in the *Phellis case* the stockholders in the New Jersey corporation retained their stock therein, whose par value was secured by debenture bonds, and received stock in the Delaware company to which all assets of the New Jersey company, with the exception of the debenture bonds, had been transferred. The Court held that under these facts the individual stockholders of the New Jersey company "received assets of exchangeable

and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit."

The question in the case at bar is whether the stockholders of the National Acme Manufacturing Company by virtue of the agreement with Eastman, Dillon & Company received assets of exchangeable and actual value severed from their capital interest in the old company. It is submitted that they did. In the *Phellis case* the New Jersey corporation, after transferring all its assets to the Delaware corporation, except an amount equivalent to its outstanding capital stock, continued to exist. The stockholders, when they received the distribution of stock from the Delaware corporation, received assets severed from their capital interest in the New Jersey corporation. A like situation is presented in this case, for while the National Acme Manufacturing Company did not continue to exist, and its assets were transferred in their entirety to The National Acme Company *after* the sale of its stock to Eastman, Dillon & Company, the stockholders thereof received assets severed from their capital interest before the transfer of the assets. That is to say, while the old corporation was in existence the stockholders sold their stock to Eastman, Dillon & Company and thereafter the assets of the old corporation were transferred to the new company. The stockholders of the old corporation received $150 cash and five shares of

stock in the new corporation for each share owned in the old corporation. Their capital interest, namely, the par value of their stock ($100), was returned in cash, and this they could use as they pleased without in any way affecting the additional amount of $50 per share and the five shares of stock in the new corporation. In other words, the additional $50 and the new stock were "*ab extra*," something drawn from, proceeding out of, capital. *Eisner* v. *Macomber*, 252 U. S. 189, 207. The $50 cash and securities received for each share of National Acme Manufacturing Company stock, therefore, constituted taxable gain severed from the capital interest.

The case of *Cullinan* v. *Walker*, 262 U. S. 134, involved the question of taxable income received by a stockholder in connection with the so-called reorganization of an oil corporation, and this Court there held that the gain accruing to a stockholder through enhancement of the value of his shares, and which, when segregated, becomes legally income subject to the income tax, may be segregated by a dividend made on liquidation of the corporation as well as by an ordinary dividend. That case arose under the same statute as is here involved. An oil corporation was dissolved. Its trustees in liquidation formed a producing corporation and a pipe line corporation in the same State. They transferred one-half of the assets to each, receiving from each in return its stock and its bonds, and transferred all this stock to a holding corporation which they formed in another State, receiving in exchange its stock. This stock,

with the bonds of the other existing corporations, they distributed among the persons who had been the stockholders of the dissolved concern. The three new corporations had at the time of the distribution no assets other than so received from the trustees, and the value of the assets was the same as when the trustees held them. This Court held that the securities thus distributed were not in legal effect a stock dividend and that the distributee was taxable under the Act of September 8, 1916, upon the amount by which the securities he received exceeded in value his investment in the shares of the original corporation. This Court, in an opinion by Mr. Justice Brandeis, said (p. 137):

> Cullinan insists that his gain so ascertained was merely an incident of a reorganization. This was equally true in the *Phellis* and the *Rockefeller Cases*. It is sought to differentiate those cases on the ground that there the distributed stock of the new corporation was technically a dividend paid out of surplus; and that here the segregation is not of that character. But the gain, which when segregated becomes legally income subject to the tax, may be segregated by a dividend in liquidation, as well as by the ordinary dividend. If the trustees in liquidation had sold all the assets for $6,000,000 in cash, and had distributed all of that, no one would question that the late stockholders of Farmers Petroleum Company would, in the aggregate, have received a gain of $5,900,000, taxable as income. The result would obviously have

been the same, if the trustees had taken in payment, and distributed, bonds of the value of $6,000,000, in some new corporations. And the result must, also, be the same where that taken in payment is $3,000,000 of such bonds and $3,000,000 in stock of a third corporation. All the material elements which differentiate the *Phellis* and *Rockefeller Cases* from *Eisner* v. *Macomber* are present also here.

Of course, in the present case the details are ifferent, but the principles are, we submit, the sa.ne. ll the assets of the old corporation were transferred o the new corporation in exchange for its capital tock. That left the old corporation with no assets xcept the capital stock of the new corporation. he old corporation was then liquidated and all that had was distributed to its stockholders, through he depositary as intermediary. The old corpora- on ceased to exist, and those who had been its tockholders received for each share of its stock 150 in cash and five shares of stock in the new orporation of a par value of $50 each, and an agreed alue of $30 each. That the new corporation was rganized under the laws of the same State as the old orporation is not material; that its powers and name ere generally similar is not material. It was a holly different entity, with a wholly different apitalization. The interest of each stockholder in he old corporation was wholly different from its nterest in the new corporation, and, as a practical natter, his power to control the new corporation as quite different. The real control had passed

from him and those with whom he had been associated and had gone to the men who had invested in the enterprise $7,500,000 in cash.

The Court of Claims in a case recently decided, *Walter L. Marr* v. *The United States*, decided November 21, 1923, regarded the case of *Cullinan* v. *Walker* as decisive of the case then before it. That court rendered a memorandum decision, which we quote in full, as follows:

> The plaintiff exchanged stock in the New Jersey corporation for stock in the Delaware corporation on the basis of five shares for one. Preferred stock was exchanged on a different basis, but all of the preferred stock was not exchanged, and holders of that kind who declined to make the proposed exchange were paid in cash for their preferred stock. Having acquired all of the stock in the New Jersey corporation, the Delaware corporation caused all of the former's assets and liabilities to be transferred to itself and the New Jersey corporation to be dissolved.
>
> The Delaware corporation had $82,600,000 of common stock and used $75,000,000 of it in acquiring the outstanding stock in the New Jersey corporation. It sold and realized cash for some of its stock in excess of that involved in the exchange. It thus had after the transfer all of the property the New Jersey corporation owned and some cash, realized, as stated, from its treasury stock.
>
> Plainly the transactions involved two distinct entities, organized under the laws of different States, with different powers, and

with different capital. Plaintiff exchanged his stock in one of these entities for stock in the other. This was an exchange of property.

When the exchange became effective we think that the plaintiff "in a legal sense realized his gain." *Cullinan* v. *Walker*, 262 U. S. 134; *Phellis case*, 257 U. S. 156; *Rockefeller case*, 257 U. S. 176.

So in the case at bar. When the exchange had been completed, each stockholder had realized his entire investment and profit in the old company, even though he immediately put part of it into a new venture.

It is submitted, therefore, that when the plaintiff below sold his stock in the National Acme Manufacturing Company for $300 a share, payable $150 in cash and $150 in securities of another corporation, he received assets of exchangeable and actual value severed from his capital interest in the Manufacturing Company, and the resulting gain constituted taxable income.

III.

The National Acme Company stock received by respondents was, in fact and legal effect, different property from the National Acme Manufacturing Company stock which they disposed of.

It was contended by the respondents that looking to the substance of the transaction, the stockholders of the National Acme Manufacturing Company sold but one-half of their interest in that company, and that the sale and subsequent organization of The National Acme Company was but a financial reorganization of the business as before constituted,

there being no loss of essential identity on the part of the company. On the other hand it was contended by the Government that the transaction was what it purported to be, a sale by the stockholders of the National Acme Manufacturing Company of all their stock in that company for cash and stock in The National Acme Company, a new, separate and distinct corporation.

It is an established principle that the ownership by one corporation of the stock of another corporation, or the ownership by the stockholders of one corporation of the stock of another corporation, does not destroy the distinct legal entity of the two corporations. *Pullman Palace Car Co.* v. *Missouri Pacific Co.*, 115 U. S. 587, 597; *Peterson* v. *Chicago, Rock Island & Pacific Ry. Co.*, 205 U. S. 364, 391.

In cases involving taxation the courts have consistently refused to disregard the principle of corporate entity. As said in *Eisner* v. *Macomber*, 252 U. S. 189, at page 214:

> * * * We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately

and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

In *Osgood* v. *Tax Commissioner*, 235 Mass. 88, there was involved the Massachusetts Income Tax Law of 1916. The facts in that case were four-square with the facts, as the plaintiff below construes them, in the case at bar. From the standpoint of the plaintiff below, therefore, the case cited is directly in point. The court said (pp. 91–92):

> On analysis, the transaction out of which this controversy arises was this: The petitioner was the owner of stocks of an ascertained value on January 1, 1916. In the following July, without selling these stocks for cash, she used them as the consideration with which to subscribe for and acquire by purchase other stocks in a new and different corporation. Although the property owned by the new corporation was identical with that owned by the old corporation, it nevertheless plainly was a different legal entity. *Brighton Packing Co.* v. *Butchers Slaughtering & Melting Association*, 211 Mass. 398. *Marsch* v. *Southern New England Railroad*, 230 Mass. 483, 498. The stock obtained by the petitioner through exchange was different in kind and not merely in degree from that which she owned before. It was not the same corporation and the stock itself was different in nature. A change of investment had been

made both in name and in essence. It would seem something of a wrench to say that the disposal of the stock in the old corporation for stock in the new is not a sale for purposes of taxation, when, if the same transaction was presented for consideration under the sales act, it would inevitably be treated as a sale. It hardly would be consistent to hold that exchanging grain for spirituous liquors was a sale constituting a crime, as was held by this court in *Commonwealth* v. *Clark*, 14 Gray, 367, and to say that exchanging stock in one corporation for stock in another corporation was not a sale for taxation purposes. Whether the disposal of the stock in the old company be treated as a strict sale or not, there seems to be no escape from holding that the procurement of the stock in the new corporation was a purchase. That word, unless narrowed by its context, signifies the acquisition of title to any commodity for cash, on credit, or for any other equivalent agreed upon. This is its ordinary meaning according to the common understanding of the business world. *Berger* v. *United States Steel Corp.*, 18 Dick. 809, 817. Doubtless there are connections in which the word is used in a more restricted sense. *Robotham* v. *Prudential Ins. Co.*, 19 Dick. 673, 685. *People* v. *Duffy-McInnerney Co.*, 122 App. Div. (N. Y.) 336, affirmed in 193 N. Y. 636. There is nothing in the context of the present statute to indicate limitations upon the natural meaning of the word. "Purchase," both in its popular and in its legal signification is broad enough to include the acquirement of stock through subscription as well as by bidding on the stock exchange.

> Tested by the difference in value of the stocks purchased as compared with those exchanged for them at their appraisal at the time fixed by § 7 of the act, the petitioner had realized a gain. * * *

See also *Stone* v. *Tax Commissioner*, 235 Mass. 93.

In *United States* v. *Phellis*, 257 U. S. 156, the taxpayer contended that the transaction there involved was but a financial reorganization of the business as it was constituted before and that there was no loss of essential identity on the part of the company.

The Court said (pp. 172–174):

> In such matters, what was done, rather than the design and purpose of the participants, should be the test. However, in this case there is no difference. The proposed plan was set out in a written communication from the president of the New Jersey corporation to the stockholders, a written assent signed by about 90 per cent of the stockholders, a written agreement made between the old company and the new, and a bill of sale made by the former to the latter, all of which are in the findings. The plan as thus proposed and adopted, and as carried out, involved the formation of a *new corporation* to take over the business and the business assets of the old; it was to be and was formed under the laws of a *different State*, which necessarily imports a different measure of responsibility to the public, and presumably different rights between stockholders and company and between stockholders *inter sese*, than before. The articles of association of neither company

are made to appear, but in favor of the asserted identity between the companies we will assume (contrary to the probabilities) that there was no significant difference here. But the new company was to have authorized capital stock aggregating $240,000,000—nearly four times the aggregate stock issues and funded debt of the old company—of which less than one-half ($118,515,900) was to be issued presently to the old company or its stockholders, leaving the future disposition of a majority of the authorized new issues still to be determined. There was no present change of officers or stockholders, but manifestly a continuation of identity in this respect depended upon continued unanimous consent or concurrent action of a multitude of individual stockholders actuated by motives and influences necessarily to some extent divergent. In the light of all this we can not regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company.

The findings show that it was intended to be established as such, and that it was so created in fact and in law. There is nothing to warrant us in treating this separateness as imaginary, unless the identity of the body of stockholders and the transfer *in solido* of the manufacturing business and assets from the old company to the new necessarily have that effect. But the identity of stockholders was

> but a temporary condition, subject to change at any moment at the option of any individual. As to the assets, the very fact of their transfer from one company to the other evidenced the actual separateness of the two companies.

In the case at bar it is clear that the stockholders of the old corporation received in addition to cash, stock in a new, separate, and distinct corporation. All the considerations, except that of incorporation under the laws of different States, mentioned by the Court in the *Phellis case* as supporting the corporate entities of the corporations there in question, are present here. Furthermore, while in the *Phellis case* the stockholders of the two corporations were identical, in the case at bar the stockholders of the National Acme Manufacturing Company and The National Acme Company were not identical. After the sale Eastman, Dillon & Company owned all the stock of the Manufacturing Company, whereas the stock of the new corporation, The National Acme Company, was owned by Eastman, Dillon & Company and the old stockholders of the Manufacturing Company.

The decisions of the Supreme Court in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, and *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, are clearly distinguishable from the instant case.

In *Southern Pacific Co.* v. *Lowe*, the Southern Pacific Company prior to March 1, 1913, owned all of the stock of the Central Pacific Railway Company and "*was in the actual physical possession of the railroads and all other assets*" and "*in charge of its*

operations," and "*acted as cashier and banker of the entire system.*" The Central Pacific kept no bank account, and if it needed money for additions or betterments or otherwise the necessary funds were advanced by the Southern Pacific. In short, the Central Pacific was a mere name, and the Court held that the Southern Pacific had the full ownership and control of the company and its property and assets. The Court expressly limited its opinion to the case before it, saying that it rested on "its very peculiar facts."

This case is distinguished in *Peabody* v. *Eisner*, 247 U. S. 347, on page 349, as follows:

> *Southern Pacific Co.* v. *Lowe*, has been reversed this day, *ante*, 330, but only upon the ground that the Central Pacific Railway Company, which paid the dividend, and the Southern Pacific Company, which received it, were in substance identical corporations because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely as its agent and subject in all things to its direction and control; and for the further reason that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend.

See also the distinction made in *Lynch* v. *Hornby*, 247 U. S. 339, on page 346.

In the *Gulf Oil Corporation case*, 248 U. S. 71, the Gulf Oil Company "was a holding company *owning all the stock* in the other corporations concerned excepting the qualifying shares held by the directors. These companies with others *constituted a single enterprise.*"

(a) *The fact that the respondents acquired no increase in aggregate wealth through the sale or exchange of their stock in the National Acme Manufacturing Company is not material in determining whether they experienced a realization of profits constituting income.*

It is submitted that the fact that the respondents acquired no increase in aggregate wealth through the sale or exchange is not material. The real question is whether they experienced a realization of profits constituting income. It seems sufficient to quote the language of the Supreme Court in *United States* v. *Phellis*, 257 U. S. 156, on this point (p. 171):

> That the distribution reduces the intrinsic capital value of the shares by an equal amount is a normal and necessary effect of all dividend distributions—whether large or small and whether paid in money or in other divisible assets—but such reduction constitutes the dividend none the less income derived by the stockholder if it represents gains previously acquired by the corporation. Hence, a comparison of aggregate values immediately before with those immediately after the dividend is not a proper test for determining whether individual income, taxable against the stock-

holder, has been received by means of the dividend.

In the present case the value of whatever the respondents received over and above the par value of their stock "represents gains previously acquired by the National Acme Manufacturing Company." Whether there was an increase in aggregate wealth is not material.

CONCLUSION.

It is submitted in conclusion that no amount of ingenious reasoning can conceal the fact that the respondents, as a result of the sale in question, received a return in cash of their original capital interest, and in addition thereto cash and securities, the value of which constituted taxable gain severed from that capital interest. The shares of stock in the National Acme Manufacturing Company were different and separate property from the shares in The National Acme Company, and the sale of the former for the latter, plus the cash consideration, gave rise to taxable income in the amount by which the cash plus the value of The National Acme Company stock exceeded the value of the National Acme Manufacturing Company stock as of March 1, 1913, or in the case of that acquired after March 1, 1913, its cost. The tax was properly assessed and collected, and the decision below should be reversed.

JAMES M. BECK,
Solicitor General.

ALFRED A. WHEAT,
Special Assistant to the Attorney General.

MARCH, 1924.

FILED
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WM. R. STANS
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No. 262.

In the Supreme Court of the United States

OCTOBER TERM, 1923.

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE,
Petitioner,

vs.

LOUIE STEARN,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR RESPONDENT.

THOMPSON, HINE & FLORY,
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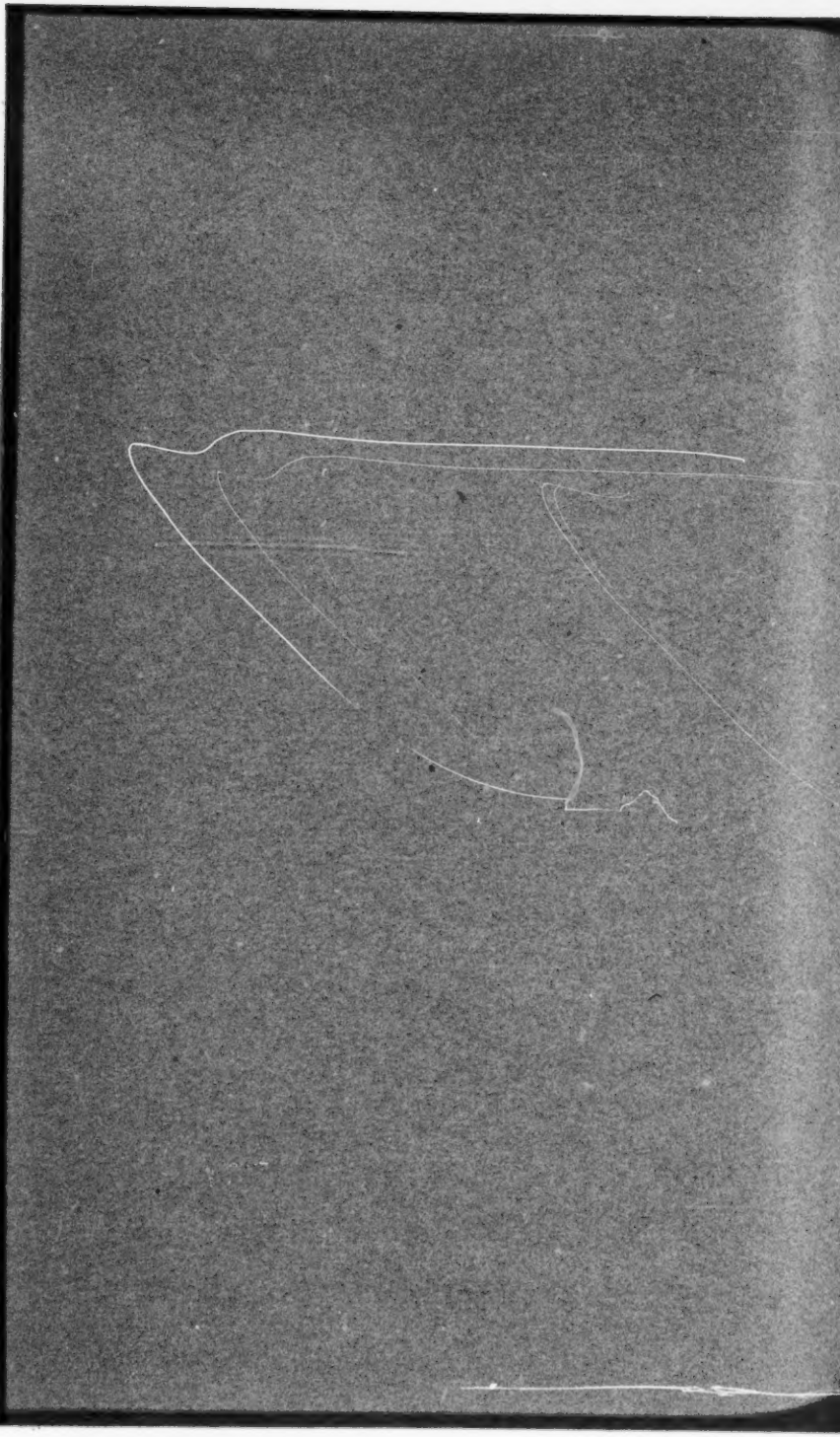

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BRIEF FOR RESPONDENT.

THE FACTS.

The case of *Weiss vs. Stearn* was submitted on an Agreed Statement of Facts printed in full on pages 11 to 13 of the record in case No. 262. The contract, which is incorporated in the Agreed Statement by reference, is printed on pages 6 to 11. The contract should be read in full, but the essential facts of the transaction are set forth concisely in the following quotation from the opinion of the Court of Appeals, Record 262, pages 33 and 34:

> "The transaction in question was had pursuant to a contract between the stockholders and Eastman, Dillon & Company, by the first paragraph of which the former apparently agreed to sell, and the latter to buy, the stock 'at and for the price of three

hundred dollars ($300) per share, payable, one-half in cash and one-half in securities, as hereinafter set forth.' But the real transaction specifically required by the subsequent provisions of the contract and actually consummated was as follows:

The stockholders delivered all of their stock to an intermediary, the Cleveland Trust Company, in trust. For each share so deposited they were to, and later did, receive $150 cash and five shares of new stock of the nominal par value of $50 each, but actually valued at $30 per share for the purposes of the bargain, being, in the aggregate, one-half (250,000 shares) of the stock of a new corporation formed to take over the business. Eastman, Dillon & Company, in order to acquire the other half of the stock of the new corporation, paid to the trustee $7,500,000, being at the rate of $30 per share for 250,000 shares. The vendors and vendees then proceeded to organize the new corporation under the laws of the same State, Ohio, with the same powers and the same name, except for the dropping of the word 'Manufacturing.' Its capital stock, $25,000,000, was five times that of the old concern, and was divided into shares of the denomination of fifty, instead of one hundred, dollars each, as theretofore. Accordingly there were ten $50 shares of the new for each $100 share of the old stock. The new corporation issued all of its stock to the trustee in exchange for all the assets subject to the liabilities of the old company. The trustee delivered one-half (250,000) of the shares of the new stock to Eastman, Dillon & Company, in consideration of the $7,500,000 paid in, and distributed pro rata among the old stockholders, the other half, 250,000 shares, and the $7,500,000 at the agreed rate of $150 and five shares of the new for each share of the old stock. The old company was then dissolved and the new corporation continued business under the same management.

The net results, putting to one side for the moment the matter of reincorporation, were that the capital stock of the concern was increased fivefold, the face value of the shares cut in half, and that the old stockholders sold Eastman, Dillon & Company, one-half of their respective holdings at the price of $30 per share for the new stock. The income tax on such profit as was made on that half which was so sold was paid by defendants in error, who were among the old stockholders. They were, however, further compelled to pay a like tax because of the receipt of the other half of the new stock in exchange for the old, the Government claiming that they made the same gain thereby as upon the half which they had sold, and for the recovery of this they sued and had judgment below.

It is clear that *the half in question was not sold to Eastman, Dillon & Company.* This is true despite the above-quoted language of the first paragraph of the agreement, as substance must dominate form; and what was done, rather than what was agreed to be done, is the final criterion. *United States v. Phellis,* 257 U. S. at page 172. *As to this half, the legal title never went to Eastman, Dillon & Company, nor beyond the Cleveland Trust Company,* which held it for the benefit of the old stockholders, in whom the equity continued until the agreed equivalent in new stock was delivered to them and the old stock retired by the dissolution of the old corporation. Therefore, *if the transaction as to this half resulted in taxable gain at all, it was not as the consequence of any sale to Eastman, Dillon & Company, but must be looked for in the transaction had between the old stockholders, the trustee, and the corporation.*

The old corporation went through the form of an exchange of its assets for the new stock and a distribution thereof among its shareholders as upon final dissolution. There was nothing that can be

properly called a sale of the half of the stock under consideration in any aspect of the case. The question to be decided resolves itself, therefore, to this: Is there taxable income to the stockholder in the receipt of shares of greater face value and actually worth more than the cost to him of old shares for which they are exchanged upon the occasion of a reorganization accomplished by the taking down of an old corporate structure and the setting up in its place of a new one with the same powers under the laws of the same State, but having greater capital stock, with a taking over of assets subject to liabilities and a continuance of the business under the same management and name?'' (italics ours)

THE QUESTION INVOLVED.

The question involved is whether the plaintiff below actually derived a profit or income measured by the difference between the cost of his stock and Three Hundred Dollars ($300.00) per share, or whether he derived an income measured by the difference between one-half of the cost of his stock and One Hundred and Fifty Dollars ($150.00) per share.

ARGUMENT.

I. The Contract Was Not For the Sale of the Stock to Eastman, Dillon & Company at $300.00 Per Share, But Was For the Sale of a Half Interest at $150.00, and the Substitution For the Other Half Interest of Stock in Which Eastman, Dillon & Company Never Had Any Interest, Legal or Equitable. The New Stock Represented a Continuation of the Same Corporate Enterprise and the Entire Equitable Interest in the Stock Which Plaintiff Received Was At All Times Owned By Him.

The fact that one clause of the contract, pursuant to which the exchange of the stock was made, recited that stockholders in the old company agree to sell their stock "for $300.00 per share, payable one-half in cash and one-half in securities, as hereinafter set forth," did not make the transaction the equivalent of a sale for cash. This is so apparent from the terms of the contract itself that we only discuss the question at all because the presence of the words "for $300.00 per share" was apparently the original basis of the ruling of the Revenue Department that the transaction was taxable as a sale. The first paragraph of the opinion of the Treasury Department in this case was:

> "That *inasmuch as a selling price or exchange value of $300.00* was placed upon each share of the National Acme Manufacturing Company's stock at the time it was sold or exchanged for five shares of stock in the National Acme Company priced or valued at $30.00 a share and $150.00 in cash, the transaction must be regarded for Federal income tax purposes, as the *sale of the stock* of the National Acme Manufacturing Company." (italics ours)

To hold that the transaction was a sale for $300.00 per share, is to ignore the words immediately following, "payable one-half in cash and *one-half in securities, as hereinafter set forth.*" The stockholders who deposited their stock under this contract *had no option to get $300.00 in cash.* The only thing they were entitled to, and the only thing they got was $150.00 for the half interest which they sold to Eastman, Dillon & Company, and five shares of new stock for the other half interest.

But, as pointed out in the Statement of Facts and in the quotation there made from the opinion below, the new stock received by the old stockholders was never owned by Eastman, Dillon & Company. The contract was of a dual nature, being in part a contract for the sale of a half interest to Eastman, Dillon & Company, and in part a reorganization agreement between the old stockholders and Eastman, Dillon & Company, providing for the creation by the vendors and purchasers of a new company to stand in the place of the old, and for the distribution by the trustee of the stock of the new company to the old stockholders and to Eastman, Dillon & Company, in proportion to their respective interests, as fixed by the trust agreement.

The brief of the Solicitor General asserts that: "The transaction between the respondents and Eastman, Dillon & Company was in fact and legal effect *a sale by the respondents of all their stock.*" But the very section of the brief which is devoted to establishing this point makes an admission which is fatal to his case and which demonstrates that the analysis of the transaction by the Circuit Court of Appeals quoted in our Statement of Facts is correct. He says:

*"Of course it is apparent that the purpose of Eastman, Dillon & Company, the purchasers, was to become the owners of a half interest in a very profitable business. * * * "*

This *was* their purpose.

Likewise it was the purpose of the old stockholders to sell a half interest in the business.

The transaction as carried out resulted in the sale of such half interest and the continuance of the same business. When the stock of the old company was deposited with the Trustee and Eastman, Dillon & Company had deposited $750,000 with the Trustee, Eastman, Dillon & Company became the owners of one-half the stock in the old company and the old stockholders retained the other half interest. The new stock was distributed by the Trustee, one-half to Eastman, Dillon & Company, and one-half to the old stockholders, and the respective interests of the stockholders in the new company were therefore exactly the same as their respective interests in the old company at the time the actual exchange of old stock for new took place.

The contention on behalf of the Revenue Department seems to be that although they concede that the purpose of the purchaser was to become the owner of a half interest in a business, and though that is all that was accomplished by the transaction as carried out, nevertheless plaintiff's tax is to be figured as if Eastman, Dillon & Company had intended to buy and had actually bought the entire business. This contention is obviously founded solely on the phraseology of portions of the contract and not on the substance and effect of the transaction.

II. Plaintiff Realized No Income From the Receipt of Stock in The National Acme Company, Since His Capital Interest in the Same Single Corporate Enterprise Continued Without Any Change in the Nature Of His Investment.

The District Judge and the three judges of the Circuit Court of Appeals reached the conclusion that no taxable income had been realized from the exchange of stock on the grounds; first, that in determining whether taxable income was realized, the substance and result of the transaction, rather than the form, must control; second, that the result of the transaction was that plaintiff retained one-half of his capital investment represented by stock, which was in substance the same as that represented by one-half of his original stock, and that he was therefore taxable only on the profit represented by the excess of the cash received over the cost of the one-half interest which he had disposed of.

This Court has repeatedly held, in construing the various income tax laws, that the determination of the question whether taxable income has been derived as the result of a particular transaction depends upon the substance of the transaction, and not upon its form.

In *Eisner vs. Macomber*, 252 U. S., at page 206, the court said:

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form."

In *United States vs. Phellis*, 257 U. S. 156, at page 168, the court said:

> "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder." (Citing *Lynch vs. Turrish*, 247 U. S. 221; *Southern Pacific vs. Lowe*, 247 U. S. 330; *Gulf Oil Co. vs. Lewellyn*, 248 U. S. 71.)

In *Eisner vs. Macomber*, the court said:

> "The fundamental relation of capital to income has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop." (252 U. S. 206.)

Applying this simile to the facts of the present case, it is clear that prior to the reorganization the capital of the owner of a share of stock in The National Acme Manufacturing Company was such share of stock. It represented plaintiff's interest as a stockholder in a single corporate enterprise. This was the tree. One-half of such interest was sold for cash, was thus severed from the tree, and taxable income resulted from such severance. But for the other half such owner received five shares of stock in The National Acme Company, which represented exactly the same proportionate interest in the same single corporate enterprise. The five shares received in exchange continued to be, in everything except name, the same tree. The tree has borne nothing different from itself, nothing which is separated from itself, nothing which can be compared to fruit. It is in every substantial respect the same tree which it was before. It has merely changed its name.

We can carry the simile of the tree a step further and say that the tree has five branches where it had one

before, but each of those branches is a part of the tree itself. When the owner sells a share of his new stock, he cuts off one of the branches, and a realization of taxable income results.

Again in the *Phellis* case, the court said:

> "The liability of a stockholder to pay an individual income tax must be tested by the effect of the transaction upon the individual." (page 174)

If, by putting the transaction which it is claimed resulted in income in this case, in another form, plaintiff could have received exactly the same stock and cash as a result of the completed transaction, without having received income, as defined in *Eisner vs. Macomber*, 252 U. S. 189, it is clear that in truth and in substance no income has been realized by plaintiff. In other words, "the effect of the transaction upon the individual" is the same, whether he arrives at a designated point by one route or by another.

III.

The Same Result Could Have Been Attained by a Process of Internal Reorganization, and if This Manner of Procedure Had Been Adopted, No Taxable Income Would Have Resulted.

Assuming that the axiom that, "Things which are equal to the same thing are equal to each other," holds good in law, as in mathematics, it can be proved with the certainty of a geometrical demonstration that the transaction between the stockholders of The National Acme Manufacturing Company and Eastman, Dillon & Company could have been carried through in a manner which would have reached identically the same result without resulting in taxable income. The demonstration

is simple. The stockholders in The National Acme Manufacturing Company could have amended its Articles of Incorporation providing for the increase of the capital stock to Twenty-five Million Dollars, the reduction of the face value of its shares to Fifty Dollars and the change of name to "The National Acme Company." They could have caused the declaration of a stock dividend, as the result of which each stockholder in The National Acme Manufacturing Company would have held ten shares of stock in The National Acme Company, of the par value of Fifty Dollars each. Each stockholder could then have sold one-half of his stock to Eastman, Dillon & Company for Thirty Dollars per share. As a result of the transaction carried out in this manner, no income would have accrued from the stock dividend. Plaintiff would have been taxable only on the profit derived from the sale of one-half his stock for cash, and he would have had, after such sale, the same identical stock and the same amount of cash which he had as the result of the actual transaction. See Opinion of Circuit Court of Appeals, Rec. 262, bottom page 35 and top page 36.

This method of reasoning out the real substantial *result* of the transaction by assuming a different corporate process, and ascertaining whether taxable income would have resulted from the assumed process, is the same adopted by this Court in the *Cullinan* case, where the court says, 262 U. S., at page 137:

> "If the trustees in liquidation had sold all the assets for $6,000,000 in cash, and had distributed all of that, no one would question that the late stockholders of Farmers' Petroleum Company would, in the aggregate, have received a gain of $5,900,000, taxable as income. The *result* would obviously have been the same, if the trustees had taken in payment,

and distributed, bonds of the value of $6,000,000, in some new corporations. And the *result* must also be the same where that taken in payment is $3,000,000 of such bonds and $3,000,000 in stock of a third corporation." (Italics ours)

The only difference between the result of the hypothetical transaction and the result of the actual transaction is that in the one case there would have been no change in the corporate entity, while in the other there has been a technical change in corporate entity. But nothing could be more shadowy and utterly lacking in substance than this difference in corporate entity, in view of the fact that the new corporation is incorporated under the laws of the same state, with the same assets, powers, purposes and officers as the old.

The conclusion seems to us irresistible that no income has in fact been realized by the receipt of the new stock, and that the Government's attempt to tax alleged income from such transaction is based upon the form of the transaction, and not on its substance.

IV.

The Mere Difference in Corporate Entity Between The National Acme Manufacturing Company and The National Acme Company is Not a Sufficient Basis for Holding That Income Was Realized by the Exchange of One Stock for the Other.

As pointed out in the opinion of the Circuit Court of Appeals, this Court has held that:

> "Where a corporate entity has been found to be a mere matter of form, it has been disregarded in similar transactions in respect to income taxation. *Southern Pacific Co. vs. Lowe*, 247 U. S. 330; *Gulf Oil Co. vs. Lewellyn*, 248 U. S. 71; *Alpha Portland*

Cement Co. vs. United States, 251 Fed. 339; although it is not so when it is a matter of substance, *Eisner vs. Macomber* and *United States vs. Phellis, supra.*" (285 Fed. 689-692)

In *Southern Pacific Co. vs. Lowe*, in which the Southern Pacific Company, a Kentucky corporation, was held not to be taxable on income received from The Central Pacific Company, a Utah corporation, out of profits accumulated by the Utah company before March 1, 1913, the court says:

> "We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And, besides, the funds represented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends." (247 U. S. p. 337)

In like manner we must assume that it was the purpose and intent of Congress to refrain from taxing as income derived from a transaction the mere increase in capital value of an investment which after such trans-

action remains in truth and in substance the same investment as before.

After Eastman, Dillon & Company acquired a one-half interest in the stock of The National Acme Manufacturing Company by depositing the cash consideration therefor, Eastman, Dillon & Company and the other stockholders of The National Acme Manufacturing Company were to unite in forming a new corporation and in causing the old company to transfer its assets to the new (Article 4 of contract, page 8). The new company was therefore a mere agency of the stockholders of the old company and subject in all things to their proper direction and control. The principle of *Southern Pacific Co. vs. Lowe* is therefore directly applicable.

The same conclusion was reached in *Gulf Oil Co. vs. Lewellyn*, 248 U. S. 71, although in that case the company which received the dividends did not itself do the business of its subsidiaries, nor have actual possession of their property, as in *Southern Pacific Co. vs. Lowe*. The court said at page 72:

> "It is true that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the fact that they were related *as parts of one enterprise, all owned by the petitioner*, that the debts were all enterprise debts due to members, and that the dividends represented earnings that had been made in former years and that practically had been converted into capital, unite to convince us that the transaction should be regarded as bookkeeping rather than as 'dividends declared and paid in the ordinary course by a corporation.'" (italics ours) (248 U. S. 72)

In the two cases last cited there was a more substantial change in the form of the investment of the

company which received the dividends than there was in the form of plaintiff's investment.

In the case of *Southern Pacific Co. vs. Lowe,* the apparent surplus of the Central Pacific Company was reduced and the aparent indebtedness of the Southern Pacific Company to the Central Pacific Company was reduced by precisely the amount of the dividends.

In the present case plaintiff merely received different certificates of stock which represented exactly the same proportionate interest in a corporation having the same stockholders, the same assets, powers, purposes and management as the original company. The ultimate facts are well summarized in a single brief paragraph of the opinion of the Court of Appeals.

> "In the present case there has been no attempt on the part of the concern to segregate or distribute its surplus, but merely a reorganization accompanied by a stock dividend. It has not been divided into two corporations, one to hold the capital, the other to take the earnings, as in the cited cases. The old charter was surrendered when the new one was taken. The venture of the stockholder in the hazard of the business continues undivided. He has not drawn out his profit. His investment is still entirely in the same enterprise, albeit represented by new certificates, yet essentially the same." (285 Fed. 689-692.)

We submit that the *ratio decidendi* of *Southern Pacific vs. Lowe* and *Gulf Oil Company vs. Lewellyn* was that the relation of the taxed corporation to the assets out of which income was alleged to have been realized remained in substance the same; it had the same ownership, direction and control over these assets in substance, but not in *form,* after the alleged transaction as it had before. So the taxed individual in this case,

prior to the transaction, had merely the ownership, direction and control incident to holding stock in an Ohio corporation, which stock represented a certain fractional interest in such assets. After the transaction, he had the same identical ownership, direction and control over such assets as he had before, being still the owner of stock in an Ohio corporation, identical except in name, which stock represented the same fractional interest in the same corporate enterprise as before.

V.

The Rule of Construction Announced in Previous Decisions Prevents a Holding That Income Was Realized by the Transaction in the Case at Bar.

In *Gould vs. Gould*, 245 U. S. 151, at 153, this Court held that the income tax law, like other taxation laws, is, in case of doubt, to be construed most strongly against the Government. That is the judicial rule of construction, but this Court is thoroughly conversant with the fact that the executive rule of construction—the rule adopted by the Treasury Department—is exactly contrary to the judicial rule, and in case of doubt as to whether income has been realized from a transaction, such doubt is always resolved by the Treasury Department in favor of the Government. Therefore, rulings by Treasury Department officials themselves, that no income is realized by transactions essentially similar to the one at bar, evidence that in the judgment of the Treasury Department the question is not even doubtful.

We submit that the fact that the Treasury Department has twice ruled that similar transactions did not result in income, and that the District Judge and the

three judges of the Circuit Court of Appeals who have passed on the facts of the instant case are of the opinion that no income was realizeed, should be persuasive in this Court that the question whether income was realized is at least doubtful, and that therefore, applying the judicial rule of construction, no taxable income was realized.

The first ruling of the Treasury Department above referred to is that of Commissioner W. H. Osborn, May 3, 1915, reported in Corporation Income Tax Service 1916, Paragraph 1779, and is as follows:

> "This office is in receipt of your letter of the 21st *ultimo*, amended by your letter of the 23rd, in which is presented the following proposition for ruling of this office:
>
> > 'A corporation having a capital stock of $500,000 has accumulated a surplus of $500,000 in addition to paying handsome dividends upon its capital stock. This company proposes to sell, or rather transfer to a reorganized company in which the stockholders and their proportionate interests are the same, all of its assets and good will for $5,000,000 par value of the second company's capital stock. The good will involved in the above proposition has been created entirely by the first company, and the earning capacity of the first company would appear to justify the suggested transaction.'
>
> * * * In the case cited the $5,000,000 capital stock issued in payment for the assets (tangible and intangible) of the first company is in fact of no greater actual value than is that of the $500,000 of the first company, for the reason that in each case the value of the stock is based upon and supported by the same assets, and until the stock issued by the purchasing or reorganized company in payment for

> the assets of the first company is converted into cash or its equivalent, no taxable income will have been realized from the transaction. In other words the excess of the nominal par value of the stock issued in payment for assets, over the nominal par value of the stock of the selling company, the stock in both cases being supported by the same assets, does not constitute income within the meaning of the Federal income tax law."

This ruling was subsequently reversed by the Treasury Department to conform to TD-2274, holding that stock dividends were taxable income (Corporation Income Tax Service 1917, Par. 1217), but TD-2274 was itself held erroneous in *Eisner vs. Macomber*, 252 U. S. 189.

Even after TD-2274 was in force, the revenue officials held that the sale to a new corporation of the assets of an old company for stock in the new company of *equal par value*, distributed share for share to stockholders of the old company, did not constitute taxable income although the stock was worth double its par value. This opinion, reported Corporation Income Tax Service 1917, Sections 2119, 2121, says in part:

> "The stock, both authorized and issued, being in both cases of like par value and being predicated upon exactly the same assets, the transaction constitutes a deal by which the second company takes over the assets of the first company, giving therefor its stock of a par value exactly equal to the par value of the stock of the first company outstanding, thus placing in the hands of the stockholders the same number of shares of the second company and same par value as that which they theretofore held in the first company, the stock in both cases being supported by the same assets. Hence the transaction resulted in no gains, profits or income to either the

first corporation or its stockholders. If, as you say, the stock of the first company at the time of this transaction, was worth 'double par', the stock of the second company being supported by identically the same assets, is presumably of the same value and the exchange of the new stock for the old, results in no income subject to tax. It is simply an exchange of assets of like character and like value."

It clearly appears from these rulings that the Revenue Department officials, after considering and reconsidering the matter, did not consider that *mere change in corporate entity,* constituted a realization of income. The distinction between the case considered in this ruling and the case at bar, i. e., the identity of the par value of the stock received with that surrendered, is of no importance since the decision in *Eisner vs. Macomber.*

We believe these decisions justify the inference that neither the legislators who passed the law nor the officials charged with enforcing it, nor the public taxed by it, regarded stock received in a reorganization, representing the same business and assets, as taxable income.

In the *Macomber* case, in considering the meaning of the word "income" in the Sixteenth Amendment, the court said that it required only "a definition of the term 'income' as used in common speech, in order to determine its meaning in the amendment." (252 U. S. 206-7.)

When the court said in the *Hornby* case "dividends are the appropriate fruit of stock ownership, *are commonly reckoned as income* and are *expended as such by the stockholder,* without regard to whether they are declared from most recent earnings or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation," it was phrasing in different language the same

thought expressed in the *Turrish* case, where it deprecates fine spun legal and economic distinctions in the interpretation of a "statute which concerns the activities of men, and intended, it might be supposed, to be without perplexities and readily solvable by the offhand conceptions of those to whom it was addressed."

The above quotations all express the thought that if a transaction does not result in income, *as the word is generally understood,* it does not result in income taxable under the constitutional amendment. The decisions of the Treasury Department above quoted, and the decisions of the four judges who considered the case, indicate that the transaction in the case at bar did not result in income, as that word is generally understood.

In attempting to reach a conclusion as to what certain language means to people in general, when such a question cannot be satisfactorily resolved by reference to dictionaries, the first test applied by an investigator is,—What does such language mean to me as applied to a transaction by me? If I had an investment in the common stock of a corporation and the corporation transferred its business, assets and liabilities, as a going concern, to another corporation formed for the purpose, which had no other business, assets or liabilities, such transfer being pursuant to a contract between myself and other stockholders that we would accept common stock in the new company in exchange for our old stock, and that the business would be carried on by the new company under the old management, would I consider that I had changed my *capital investment,* or that I had *realized* a profit? We believe there can be but one answer to these questions.

If, as a part of a single transaction, I sold half of my stock interest for cash, and took stock in a new com-

pany formed as aforesaid, in exchange for the other half interest, the answer must be the same as to the half interest exchanged for stock. If the new corporation was formed under the laws of the same state, and with the same powers as the old, so that the same result could have been attained by a mere process of internal reorganization, and if it was already settled law that the result arrived at in that manner would not result in income, would I not be doubly justified in my conclusion?

We believe that in the consideration of this case each judge must ask himself these questions, and that all must come to the same conclusion.

VI.

The Cases Relied On by the Government Are Not Applicable to the Facts of the Present Case.

The Solicitor General relies principally upon the case of *United States vs. Phellis*, 257 U. S. 156. The decision in this case was rendered before the decision in the case at bar in the District Court, and was fully considered and distinguished both by that court and the Court of Appeals. Referring to the *Phellis* case, the Circuit Court of Appeals said, at Page 692:

> "The latter case, strongly relied upon by plaintiff in error, does not present a parallel situation. There the surplus had been separated from the capital for the purpose of distributing it among the stockholders in the form of the stock of a new corporation to which the assets were conveyed. But the old corporation continued to exist, its stock remained outstanding, and the segregation of capital from surplus was accomplished by setting over to it assets equal to its capital stock and capable of returning future dividends to its stockholders."

We regard it as most significant that this Court, in the recent case of *Cullinan vs. Walker*, 262 U. S. 134, decided April 30, 1923, dealing with the distribution of stock of a Delaware holding company, for stock in a producing and pipe line company, expressly mentioned as the "*material elements*" which distinguished the facts of the *Phellis* case from the facts in *Eisner vs. Macomber*, two points of distinction which clearly distinguish the case at bar from the *Phellis* case. The court said:

> "All the material elements which differentiate the *Phellis* and *Rockefeller* cases from *Eisner vs. Macomber* are present also here. The corporation whose stock the Trustees distributed was a *holding company*. In this respect it differed from Farmers Petroleum Company which was a producing and pipe line company. It differed from the latter also because it was *organized under the laws of another state.*" (Italics ours) 137.

In the case at bar none of the aforesaid material elements which differentiate the *Phellis* and *Rockefeller* cases from *Eisner vs. Macomber* are present. The National Acme Company, whose stock was received in exchange, was not a holding company, but an operating company, with the same powers and purposes, management and assets as the original company. It was formed under the laws of the same state, and the ultimate result of the transaction was identically the same as if there had been no change in the corporate entity.

In addition to the two points of distinction stressed as material in the *Cullinan* case, there are other important distinctions between the facts in the present case and the facts upon which the court based its judgment in the *Phellis* case.

In the *Phellis* case this Court stated:

> "Each holder of the New Jersey company's common stock, (including claimant), *retained his old stock*, and besides received a dividend of two shares for one in stock of the Delaware company, and the New Jersey company *retained in its treasury six per cent. debenture stock of the Delaware company* equivalent to the par value of its own outstanding common stock." (Italics ours) 257 U. S. 156, at p. 167.

In the present case the stockholders did not retain heir stock in the old company, and the old company re-ained nothing in its treasury.

In the *Phellis* case this Court said:

> "After the reorganization and distribution of the stock of the Delaware company the New Jersey company continued as a going concern and still exists." (page 167)

In the present case the old corporation was dis-olved.

While we do not believe that the case of *Marr vs. nited States*, cited on page 20 of Petitioner's brief, was orrectly decided, the facts of that case are essentially fferent from this, since the new corporation was in-rporated under the laws of a different state, with dif-ent powers, and had additional assets. The result at-ined by the exchange in the *Marr* case could not have en attained by a mere process of internal reorganiza-on, stock dividend, and sale of half the increased stock. hat judgment could be affirmed without putting this ourt in the position of holding that the existence of xable income depends, not upon the result of the trans-tion, but upon the manner in which it is carried out. See *supra* Subdivision III)

The Petitioner also relies upon and quotes from the case of *Osgood vs. Tax Commissioner,* 235 Mass. 88. In the sentence immediately following the quotation from the *Osgood* case in Petitioner's brief, page 23, the court cited *Tax Commissioners vs. Putnam,* 227 Mass. 522, as the basis for its holding that a profit had been realized. The *Putnam* case held that stock dividends were taxable as a realization of income. Having held that a mere multiplication of shares through a stock dividend constituted taxable income, the court naturally held that a multiplication of shares through a reorganization likewise constituted a realization of income. But the *Putnam* case was disapproved by this Court in *Eisner vs. Macomber,* and the *Osgood* case is therefore of no weight in this jurisdiction. It appears, further, that in that case the plaintiff had exchanged common *and preferred* stock for common stock in the new company.

The facts of the present case are different from those in any case heretofore decided by this Court. In substance the case is essentially similar to *Eisner vs. Macomber,* and the principles announced in that case should govern the decision in this. It is essentially different from the *Phellis, Rockefeller* and *Cullinan* cases in that there was an unbroken continuance of the same corporate enterprise by a single corporation of the same state, without segregation of capital and surplus, without segregation of different branches of the business to separate corporations, and without changing the form of the stockholders' investment from common stock in the operating company to any other form of security.

Since the ultimate result of the transaction could have been reached without any change in corporate entity, and since the new company is an operating company, formed under the laws of the same state and with

the same powers and purposes as the old company, and since the stockholders' interest in the capital of the company continues to be represented by stock in the operating company in no manner different from the change which would have resulted from an amendment of the Articles and a non-taxable stock dividend, we submit that this Court cannot hold that taxable income resulted from the exchange of securities, without abandoning the fundamental principle that the existence of taxable income must be determined "according to truth and substance, without regard to form."

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Of Counsel.

In the Supreme Court of the United States.

OCTOBER TERM, 1922.

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE, petitioner,
v.
JOHN G. WHITE, RESPONDENT. } No. —.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

The Solicitor General, on behalf of Harry H. Weiss, Collector of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Sixth Circuit rendered in the above-entitled case on January 9, 1923, affirming a judgment entered by the District Court allowing the respondent to recover taxes paid under protest.

STATEMENT.

This is an action brought by the respondent to recover taxes assessed and paid to the Government, under protest, by virtue of the Revenue Law of 1916 (39 Stat. 757), upon shares of stock received in the National Acme Company growing out of an apparent

sale and termination of the National Acme Manufacturing Company.

This case was tried in the District Court and resulted in judgment for the respondent. The Circuit Court of Appeals, taking the view that the transaction was merely a reorganization accompanied by a stock dividend, affirmed the judgment. Petitioner now seeks to have this judgment of the Circuit Court of Appeals affirming the judgment of the District Court reviewed by certiorari.

QUESTION INVOLVED.

The sole question involved is whether the respondent should be regarded for the purpose of income taxation under the Revenue Law of 1916 (39 Stat. 757) as having disposed of, with profit, only one-half of his respective holdings in the National Acme Manufacturing Company, or whether he should have been considered as having so disposed of the entirety.

THE FACTS.

Under a contract between the stockholders of the National Acme Manufacturing Company and Eastman, Dillon & Company, the stockholders sold all of the stock in the National Acme Manufacturing Company to the latter company and received for each share of the old stock $150 in cash and five shares in a newly organized "National Acme Company." Eastman, Dillon & Company, by virtue of this transaction, acquired a one-half interest in the newly organized company.

The petitioner contends that the profit was the difference between the March 1, 1913, value of the stock of the old National Acme Manufacturing Company and the entire consideration received in exchange therefor, consisting of cash and stock of the new National Acme Company.

REASONS FOR GRANTING THE PETITION.

1. The decision of the Circuit Court of Appeals is detrimental to the interests of the Government in the collection of revenue under the Revenue Law of 1916, as it is directly opposite to the ruling of the Treasury Department in pursuance of which large amounts of taxes have already been collected. If the decision stands, numerous other suits may be expected, with strong possibility of conflicting decisions in other circuits.

2. The question is of grave importance to the administration of the Internal Revenue Laws, which this decision leaves in great confusion.

3. The Circuit Court of Appeals erred in holding that the distribution upon reorganization of the new stock in exchange for the old did not involve taxable income.

JAMES M. BECK,
Solicitor General.

BRIEF IN SUPPORT OF THE PETITION.

I.

The court erred in holding that while as to one half of the stock in the National Acme Manufacturing Company there was a sale from which the stockholders derived taxable income, yet as to the other half of the stock there was an exchange of stock for stock out of which exchange the old stockholders of the National Acme Manufacturing Company received no taxable income, but only a stock dividend.

The stockholders sold their shares in the National Acme Manufacturing Company for $150 cash and five (5) shares of stock in the new company for each share of stock in the old, the assets of the old company, including surplus, having been transferred to the new company. Certainly the undivided interest of the individual stockholder in the surplus accumulated had been released to and drawn by him as profit or income from his original capital investment. The distribution in stock to the stockholders of the National Acme Manufacturing Company resulted in taxable income regardless of the fact that this company was dissolved and never continued as a going concern after said distribution. The distribution in the present case can not be said to be a stock dividend, for in *Eisner* v. *Macomber*, 252 U. S. 189, 202, 203, it is stated that the essentials of a true stock dividend are that "a stock dividend really takes nothing from

the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same."

In the present case the transaction was a sale of all of the stock of the National Acme Manufacturing Company and, while the corporate assets may have been the same upon its completion as they were at its inception, it is certainly not true that stockholding interests were identical. It is believed that this question has been conclusively settled by the case of *United States* v. *Phellis*, 257 U. S. 156, wherein it was held that the distribution constituted a property dividend and was taxable as such in the hands of the stockholders. The court pointed out (p. 169) that—

> Hence the inquiry must be whether the shares of stock in the new company received by claimant as a dividend by reason of his ownership of stock in the old company constituted (to apply the tests laid down in *Eisner* v. *Macomber*, 252 U. S. 189, 207), a gain derived from capital, not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested, and coming in, that is, received or drawn by the claimant for his separate use, benefit and disposal.

The distribution in question surely resulted in taxable income to the stockholders of the old company in the form of profit derived from the sale and exchange of their shares of stock in the National Acme Manufacturing Company for shares of stock in the National Acme Company and cash. The measure of the profit, gain, and income so derived is the difference between the fair market value of the stock of the National Acme Manufacturing Company on March 1, 1913, and the value of the entire consideration received in payment thereof, i. e., five shares of stock of the National Acme Company and $150 in cash for each share of stock of the National Acme Manufacturing Company.

Merchants Loan & Trust Company v. *Smietanka*, 255 U. S. 509.
Goodrich v. *Edwards*, 255 U. S. 527.
Walsh v. *Brewster*, 255 U. S. 536.

CONCLUSION.

It is respectfully submitted that a writ of certiorari should issue to review the judgment of the Circuit Court of Appeals for the Sixth Circuit to the end that it may be reversed.

JAMES M. BECK,
Solicitor General.

MABEL WALKER WILLEBRANDT,
Assistant Attorney General.

JOHN C. HAYES,
Special Assistant to the Attorney General.

APRIL, 1923.

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